

**THE SOCIAL SECURITY EARNINGS TEST AND OPTIONS FOR CHANGE**

Staff Working Paper  
September 1988

Congress of the United States  
Congressional Budget Office



## PREFACE

---

Numerous bills have been introduced in the Congress to raise or eliminate the Social Security earnings test limit for people aged 65 through 69. At the request of the Subcommittee on Social Security of the Committee on Ways and Means, the Congressional Budget Office (CBO) prepared this paper examining who among those aged 65 through 69 are affected by the current earnings test and who would no longer be affected if the earnings test were liberalized or eliminated.

Roberton Williams of the Human Resources and Community Development Division wrote the paper under the direction of Nancy Gordon and Ralph Smith. Paul Cullinan of the Budget Analysis Division prepared estimates of budgetary effects. Roald Euler wrote the computer programs to tabulate extensive data. Paul Cullinan, Richard Kasten, and David Lindeman reviewed various drafts of the paper. Amanda Balestrieri edited the manuscript, and Ronald Moore prepared the paper for publication.

In accordance with CBO's mandate to provide objective analysis, the paper makes no recommendations. Questions should be directed to Roberton Williams of CBO's Human Resources and Community Development Division at (202) 226-2663.



## CONTENTS

---

SUMMARY . . . . .	vii
I THE CURRENT EARNINGS TEST . . . . .	1
How the Earnings Test Works . . . . .	1
Data and Limitations of the Analysis . . . . .	4
People Affected by the Earnings Test in 1986 . . . . .	6
II EFFECTS OF CHANGING THE EARNINGS LIMIT . . . . .	15
Which Groups Would Be Affected? . . . . .	15
Which Beneficiaries Would Be Made Exempt? . . . . .	16
Effects on Federal Outlays . . . . .	25
APPENDIXES	
A Effects of Changes in the Social Security Earning Test, by Family Income, by Income Relative to Poverty Thresholds, and by Living Arrangement, 1986 . . . . .	28
B Effects of Changes in the Social Security Earnings Test, by Living Arrangement and Income Relative to Poverty Thresholds, 1986 . . . . .	36



## TABLES

1.	Reported and Imputed Social Security Eligibility in 1986 of People Aged 65-69 with Earnings Above \$7,800 . . . . .	7
2.	Effects on Outlays of Options for Changing the Social Security Earnings Test, 1989-1993 . . . . .	26
A-1.	Distribution in 1986 of People Aged 65-69 Eligible to Receive Social Security Benefits, by Family Income and Earnings . . . . .	29
A-2.	Distribution in 1986 of People Aged 65-69 Eligible to Receive Social Security Benefits, by Family Income Relative to Poverty Thresholds and Earnings . . . . .	30
A-3.	Distribution in 1986 of People Aged 65-69 Eligible to Receive Social Security Benefits, by Living Arrangement and Earnings . . . . .	31
A-4.	Number of People Aged 65-69 Affected in 1986 by the Social Security Earnings Test Who Would Not Have Been Affected Under Alternative Earnings Limits . . . . .	32
A-5.	Distribution in 1986 of People Aged 65-69 Eligible to Receive Social Security Benefits and Those Who Would Not Have Been Affected Under Alternative Earnings Limits, by Family Income . . . . .	33
A-6.	Distribution in 1986 of People Aged 65-69 Eligible to Receive Social Security Benefits and Those Who Would Not Have Been Affected Under Alternative Earnings Limits, by Family Income Relative to Poverty Thresholds . . . . .	34
A-7.	Distribution in 1986 of People Aged 65-69 Eligible to Receive Social Security Benefits and Those Who Would Not Have Been Affected Under Alternative Earnings Limits, by Living Arrangement . . . . .	35
B-1.	Distribution in 1986 of People Aged 65-69 Eligible for Social Security, by Living Arrangement and Family Income Relative to Poverty Thresholds . . . . .	37
B-2.	Distribution in 1986 of People Aged 65-69 Made Exempt from the Earnings Test by Raising the Earnings Limit from \$7,800 to \$9,000, by Living Arrangement and Family Income Relative to Poverty Thresholds . . . . .	38





B-3. Distribution in 1986 of People Aged 65-69 Made Exempt from the Earnings Test by Raising the Earnings Limit from \$7,800 to \$15,600, by Living Arrangement and Family Income Relative to Poverty Thresholds . . .	39
B-4. Distribution in 1986 of People Aged 65-69 Made Exempt from the Earnings Test by Raising the Earnings Limit from \$7,800 to \$22,560, by Living Arrangement and Family Income Relative to Poverty Thresholds . . .	40
B-5. Distribution in 1986 of People Aged 65-69 Made Exempt by Eliminating the Earnings Test, by Living Arrangement and Family Income Relative to Poverty Thresholds . . .	41

#### FIGURES

1. Distribution in 1986 of People Aged 65-69 Eligible for Social Security Benefits and Affected by the Earnings Test, by Family Income . . . . .	9
2. Distribution in 1986 of People Aged 65-69 Eligible for Social Security Benefits and Affected by the Earnings Test, by Family Income Relative to Poverty Thresholds . . . . .	11
3. Distribution in 1986 of People Aged 65-69 Eligible for Social Security Benefits and Affected by the Earnings Test, by Living Arrangement . . . . .	12
4. Distribution in 1986 of People Aged 65-69 Eligible for Social Security Benefits and People Affected by the Earnings Test, by Family Income . . . . .	13
5. Distribution in 1986 of People Aged 65-69 Eligible for Social Security Benefits and People Affected by the Earnings Test, by Family Income Relative to Poverty Thresholds . . . . .	14
6. People Aged 65-69 No Longer Affected by the Earnings Test in 1986 as a Result of Selected Changes, by Sex .	17
7. People Aged 65-69 No Longer Affected by the Earnings Test in 1986 as a Result of Selected Changes, by Family Income . . . . .	18
8. People Aged 65-69 No Longer Affected by the Earnings Test in 1986 as a Result of Selected Changes, by Family Income Relative to Poverty Thresholds . . . . .	20



9. People Aged 65-69 No Longer Affected by the Earnings Test in 1986 as a Result of Selected Changes, by Living Arrangement . . . . . 21
10. Distribution in 1986 of People Aged 65-69 No Longer Affected by the Earnings Test as a Result of Selected Changes, by Family Income . . . . . 22
11. Distribution in 1986 of People Aged 65-69 No Longer Affected by the Earnings Test as a Result of Selected Changes, by Family Income Relative to Poverty Thresholds . . . . . 23
12. Distribution in 1986 of People Aged 65-69 No Longer Affected by the Earnings Test as a Result of Selected Changes, by Living Arrangement . . . . . 24



## SUMMARY

This analysis examines two aspects of modifying the Social Security earnings test for people aged 65 through 69: the impact on beneficiaries currently affected by the earnings test of selected options for raising earnings limits, and the budgetary effects of those options. The paper does not consider other factors related to changing the earnings test, such as administrative cost savings from simplifying the test, or the labor supply response of beneficiaries--that is, whether they would choose to work more or less than they do under current law.

In 1988, the earnings test reduces payments to beneficiaries between the ages of 65 and 69 by \$1 for each \$2 of earnings in excess of the exempt limit of \$8,400. The analysis, however, focuses on the effects of the earnings test in 1986, the most recent year for which data are available. In that year, the earnings limit for people aged 65 through 69 was \$7,800. In addition, because the analysis is based on data from the Current Population Survey, small differences may exist between the findings of this paper and program statistics from the Social Security Administration.

### PEOPLE AFFECTED BY THE EARNINGS TEST

In 1986, more than 8 million people aged 65 through 69 received or were eligible to receive Social Security benefits. (Unless otherwise stated, references are to calendar years.) This number--and all numbers in the analysis of characteristics of people affected by the earnings test--excludes people who appear to have retired during 1986, since available data do not show whether they would have been affected by the earnings test.

Almost one-fifth of potential Social Security recipients aged 65 through 69--nearly 1.6 million people--had some earnings in 1986, but only about 600,000 of them received lower benefits because of the earnings test. This affected group made up less than two-fifths of earners and less than 10 percent of all who were eligible for benefits. They were affected either by payment reductions or because they delayed applying for benefits. (Other beneficiaries may have limited their earnings in order to receive full benefits, but the data necessary to include them in the analysis are not available.)

Those affected by the earnings test were more likely than those not affected:

- o to be men;
- o to live with their spouses;
- o to have family incomes above \$32,000; and



- o to have family incomes above four times the poverty threshold--that is, above about \$21,000 for a single person and about \$26,500 for a couple.

Only 1 percent of those affected by the earnings test had family incomes below twice the poverty threshold--that is, below about \$10,500 for a single person and about \$13,300 for a couple--compared with roughly one-third of all people aged 65 through 69 eligible for Social Security.

#### EFFECTS OF CHANGING THE EARNINGS LIMIT

This analysis examines the number and characteristics of people who would no longer incur benefit reductions if the earnings limit were raised or eliminated, as well as the increase in budgetary outlays such changes would cause. Because of limitations of the Current Population Survey data, however, the analysis does not show the amounts by which Social Security payments would rise for different groups of recipients. (While changes in benefit levels could be calculated using data from other sources, those other sources lack information on family incomes and living arrangements.) In addition, the analysis of the characteristics of people affected by modifications to the earnings test excludes both recent retirees subject to a monthly earnings test and dependents whose benefits are affected by workers' earnings; these groups are, however, included in estimates of budgetary effects.

The analysis of the characteristics of beneficiaries who would be affected by a modified earnings test does not account for any behavioral changes that might be induced by increasing the earnings limit. A higher limit might cause some Social Security beneficiaries to work more than they now do, and thus to pay additional payroll and income taxes. At the same time, some workers may elect to apply for Social Security benefits earlier than they would under the current earnings test; this would increase benefits currently paid, but reduce future benefits since fewer such workers would receive delayed retirement credits. The aggregate effect of such behavioral shifts is reflected in this study's budgetary estimates.

The analysis examines four possible changes to the earnings test:

- o Raise the earnings limit to \$10,000 in 1989. A comparable limit (of about \$9,000) would have exempted about 85,000 people in 1986, about 14 percent of all those actually affected by the earnings test.
- o Double the earnings limit to an estimated \$17,280 in 1989. In this case, nearly 270,000 of those affected by the actual earnings test--45 percent--would not have been affected in 1986.





- o Raise the earnings limit to \$25,000 in 1989. In 1986, a comparable limit (of about \$22,560) would have exempted about 375,000 people, nearly two-thirds of those affected under current law.
- o Eliminate the earnings test. All 600,000 affected people would have been eligible for higher benefits.

Three conclusions stand out with respect to these four options:

- o Gains would go primarily to people with high family incomes. Under each of the options, at least 72 percent of the people made exempt from the earnings test would have incomes greater than three times the poverty level--that is, greater than about \$15,800 for a single person and about \$19,900 for a couple.
- o All four options would focus gains on men living with their spouses in families with incomes greater than four times the poverty level.
- o Among those affected by the earnings test, most women, widows and widowers, and people with low family incomes would become exempt if the earnings limit were doubled. In contrast, raising the limit further or eliminating it would focus the additional gains on men, married couples, and people with high family incomes.

Federal budget outlays for Social Security would increase for each of the options over the next five years, but costs would be much higher for the larger changes. For example, raising the earnings limit to \$10,000 in 1989 would increase outlays by about \$1.3 billion over the 1989-1993 period, but doubling it (to \$17,280 in 1989) would cost over six times as much--more than \$8 billion over the five-year period. Increasing the 1989 earnings limit to \$25,000 would raise outlays by nearly \$11 billion over the 1989-1993 period, while eliminating it entirely would cost nearly \$24 billion over the same five years.

Because estimating practices used by the Congressional Budget Office rely on a baseline macroeconomic forecast which incorporates projections of aggregate wages and employment, no revenue effects are estimated for the options to change the earnings test. However, when revenue effects have been considered--as they are in the Social Security Administration's estimates--they offset only a small portion of the additional benefit costs.



## CHAPTER I

### THE CURRENT EARNINGS TEST

This paper deals with two issues concerning possible changes in the Social Security earnings test for people aged 65 through 69: how selected options to raise or eliminate earnings limits would affect recipients whose benefits are currently reduced as a result of the test, and how those changes would affect federal budget outlays for Social Security. The analysis excludes all beneficiaries who retired during the year, and does not take account of possible behavioral responses to the changes. Furthermore, the paper does not consider related effects such as the simplification of administrative procedures.

Before looking at the effects of relaxing or eliminating the earnings test, it is useful to look more closely at the current earnings test and examine the characteristics of those beneficiaries it affects. Moreover, the constraints imposed on this analysis by the limitations of the available data require some explanation.

#### HOW THE EARNINGS TEST WORKS

In 1988, Social Security recipients aged 65 through 69 are subject to an earnings test that reduces their benefits by \$1 for each \$2 they earn above the exempt limit of \$8,400.<sup>1/</sup> A special monthly earnings test applies in the calendar year in which benefits are first received. If a retired worker earns more than the exempt amount, the benefits of all people receiving payments based on the worker's earnings record are subject to the reduction. Excess earnings of dependents and survivors, however, affect only their own benefits and not those of other family members.<sup>2/</sup>

- 
1. Beginning in 1990, people aged 65 through 69 will have their benefits reduced by \$1 for every \$3 in earnings in excess of the exempt limit. While this policy change will not affect which people are subject to the earnings test, for many beneficiaries it will mean higher benefits than they would otherwise get.

Beneficiaries under age 65 are also subject to the earnings test, but the limit on earnings is lower--\$6,120 in 1988. In addition, the rate of benefit reduction for these younger workers is scheduled to remain at \$1 for every \$2 of earnings over the exempt limit. Beneficiaries are no longer subject to the earnings test once they reach age 70.

2. The impact of the earnings test is actually somewhat more complicated than this simplified description indicates. In particular, if total family benefits are limited by the maximum family benefit, some members may be able to earn more than the exempt amount without reducing Social Security payments to the family.



Three groups of workers and their families are affected by the earnings test. The main group is Social Security beneficiaries with earnings above the relevant exempt amount. This group includes both those who get no Social Security payments because the reduction caused by the earnings test exceeds their benefit level, and those who get smaller--but still positive--benefits.

A second group includes workers who delay their application for Social Security benefits. This situation may occur because such people want or need to continue working and either expect their benefits to be fully withheld under the earnings test--and thus do not bother to apply--or do not want to have their Social Security payments reduced.<sup>3/</sup>

The third group of affected people is Social Security recipients who limit their earnings so that their benefits are not reduced. Some of these people elect not to work at all, while others work fewer hours than they would otherwise to hold their annual earnings below the exempt amounts.

Retired workers whose earnings over the exempt limit cause them to lose benefits are compensated either through the delayed retirement credit--which increases benefits by 1/4 percent for each month in which benefits are reduced--or through a reversal of the early retirement reduction.<sup>4/</sup> If these two factors were fair on an actuarial basis, the earnings test would simply defer benefits;

- 
3. As discussed in the next footnote, people who have benefits withheld because of the earnings test receive future benefits that are higher than they would otherwise be. Whether or not such adjustments are actuarially fair, beneficiaries may perceive the loss of benefits through the earnings test to be permanent, and thus fail to apply for benefits.
  4. Benefits are reduced by 5/9 percent for each month under age 65 that a worker is when he or she first receives Social Security old age benefits. Before the worker's 65th birthday, for each month in which benefits are withheld because of the earnings test, one month's early retirement reduction is restored. Once the worker turns 65, the delayed retirement credit increases benefits by 1/4 percent in 1988--rising to 2/3 percent for people who turn age 62 in 2005 and after--for each month in which the earnings test causes benefits to be partially or fully withheld.



higher future benefits would, on average, offset the value of reduced current benefits.<sup>5/</sup>

Analysts claim that although the early retirement reduction is approximately actuarially fair, the current delayed retirement credit is too low, so the earnings test now imposes a long-run penalty. In fact, the delayed retirement credit is slowly being raised to 2/3 percent per month for people who turn age 62 in 2005 and later years, after which it too should be close to actuarially fair. Once that is the case, the earnings test will serve only to shift the timing of benefit payments--and hence, of federal expenditures--into the future.

Any individual's experience may nevertheless be better or worse, since an actuarially fair adjustment is only fair on average. Some people will lose benefits because they die earlier than expected, while others will gain because they live longer. To the extent that there is adverse selection among those deciding to retire early or work longer--that is, people in worse health retire early and those in better health work longer--this situation is exacerbated: the less healthy early retirees may die at younger ages and thus suffer disproportionately greater losses, while the healthier late retirees may live longer and receive even greater benefits.

Another factor that influences the effects of the earnings test is the taxation of Social Security benefits for people with incomes above fixed limits. (Income is distinct from earnings: earnings are wages, salaries, and income from self-employment, and are only part of total income.) Up to half of Social Security income is taxable if the sum of one-half of Social Security and Railroad Retirement income plus all of adjusted gross income and tax-exempt interest exceeds \$25,000 for single people or \$32,000 for married couples filing jointly. Because those with higher incomes must pay taxes on half of their Social Security benefits, the net impact of having those benefits withheld because of the earnings test is less than it would otherwise be. Furthermore, to the extent that their incomes will be lower when their earnings drop below the earnings test limit, recipients may be subject to lower tax rates when they do receive their higher benefits in the future.

- 
5. This is true by definition: benefit adjustments are actuarially fair if forgone (or additional) payments today are equal, on average, to the present value of expected additional (or reduced) benefits in the future. Future benefits are adjusted even if only part of a month's payment is withheld because of the earnings test. While such adjustments somewhat overcompensate for partial withholding, this would not be expected to have a major effect on actuarial fairness.





Proponents of easing or eliminating the earnings test assert that Social Security is primarily a pension for which workers have paid through payroll taxes, and that it is unfair to penalize those who continue to work. They point to the high effective marginal tax rates on earnings for those subject to benefit reductions: in addition to the 50 percent tax imposed by the earnings test, workers with taxable incomes in the lowest tax bracket also pay 15 percent in federal income taxes and 7.51 percent in Social Security and Medicare taxes--a total marginal tax rate of more than 72 percent --plus any state and local income and payroll taxes, during the phase-out range of their Social Security benefits.<sup>6/</sup> Besides this adverse impact on recipients, critics point to the administrative complexity which the earnings test imposes: beneficiaries are required to file annual statements of expected earnings, and the Social Security Administration must adjust payments, credit workers' records with their additional earnings, apply delayed retirement credits, and correct retroactively for over- and underpayments, all at significant expense. (The Social Security Administration estimates that retroactive correction of mispayments is required for 80 percent of people who have benefits withheld because of the earnings test.)

Proponents of retaining the current earnings test base their support on the belief that the major purpose of Social Security is to replace earnings lost as a result of retirement, death, or disability. To the extent that beneficiaries continue to have substantial earnings, they argue, there is less need for replacement and benefits should be reduced. Furthermore, they dispute the claim that Social Security is a pension, arguing that the benefit structure--paying relatively more to those with low earnings than to those with high earnings, and providing rates of return on contributions much higher than private pensions, at least for current retirees--is unlike that of pensions.

#### DATA AND LIMITATIONS OF THE ANALYSIS

This analysis is based on data from the March 1987 Current Population Survey (CPS), which contains information about incomes received during calendar year 1986. While this is the most recent year for which such data exist, 1986 may not provide an accurate representation of economic conditions today or in the future. In particular, the overall civilian unemployment rate in 1986 was 7.0 percent, but it is projected by the Congressional Budget Office (CBO) to be significantly lower in 1988 and subsequent years. It is uncertain how the current tight labor markets affect the employment of the elderly, but the increased availability of jobs may induce more elderly people to work. In light of these facts,

- 
6. In 1990, when the benefit reduction in the earnings test falls to one-third, this marginal tax rate will drop to about 56 percent, plus any state or local tax rates.



some caution is in order in using these findings to predict the future. In 1986, the exempt earnings limit for beneficiaries between the ages of 65 and 69 was \$7,800.<sup>7/</sup>

Unfortunately, the limitations of these data from the CPS impose two constraints on the analysis. First, because respondents report their eligibility for Social Security only if they received payments during the year, the analysis cannot identify either those whose benefits are completely withheld because of high earnings or those who have not yet applied for benefits. Because there is little information to determine which people not reporting Social Security income are eligible to receive payments, the analysis assumes that all people aged 65 through 69 who had earnings were eligible.<sup>8/</sup> This assumption imputed eligibility for roughly 250,000 people.

A second constraint exists because the CPS does not indicate the amount of Social Security beneficiaries would receive if their payments were not reduced by the earnings test. The amounts reported on the CPS may be before or after reductions, or they may include lump-sum adjustments--either reductions or repayments--based on Social Security actions in previous years. Because recipients' basic benefit levels are unknown, CBO cannot estimate how much individual benefits are reduced because of the earnings test. As a result, the analysis is limited to examining the characteristics of people affected by the current earnings test and of those who would no longer be affected if the earnings test limit were raised or eliminated. In addition, it is impossible to determine whether a worker's earnings in excess of the earnings limit affect benefits payable to his or her dependents; consequently, such dependents are omitted from the examination of the characteristics of people affected by the earnings test.

- 
7. The earnings limit is indexed to the national average of wages reported to the Social Security Administration on W-2 tax forms. Such indexing applies, however, only when the average wage rises; the law precludes any reduction in the earnings limit. Recent limits have been:

1983	\$6,600	1986	\$7,800
1984	\$6,960	1987	\$8,160
1985	\$7,320	1988	\$8,400

CBO projects the limit to be \$8,640 in 1989 and \$9,120 in 1990.

8. Some of these people might have received benefits but inaccurately reported on the CPS that they did not. This might be particularly likely in the case of dependents, for whom benefits might be lumped in with a retired worker's payments.

